

The financial-reporting authority, who specializes in issues related to intangible assets, explains how to measure organizational capital and put an end to the 'information brownout'

Thought Leader Interview:

Baruch Lev

by Karen Christensen

You have called 'organizational capital' the most important contributor to corporate performance and growth. How do you define it?

It is widely observed that within industries or economic sectors, some firms systematically outperform their competitors. Organizational capital is the sum total of all the systems, processes and procedures that these companies use to conduct their business. For example, years ago **Wal-Mart** was the first to implement a supply-chain management approach whereby, when a customer paid for an item at the cash register, the bar code was read and the information went directly to a supplier like **Procter & Gamble**, who was then responsible for replenishing the inventory. With this specific process, the largest retailer in the world managed to shift the most expensive function for retailers – inventory and supply-chain management – to its suppliers, with enormous cost savings. And so it goes for **Dell** in PCs, **Microsoft** in software, **UPS** and **Federal Express** in shipping, **Goldman Sachs** in investment banking, and **Southwest** among airlines: I could provide an infinite number of examples of the unique systems, processes and training they employ, and the sum total for each of them is their 'organizational capital'. The competitive advantages conferred by such capital are mainly due to the fact that these resources cannot be completely codified and transferred to other organizations.

Such 'intangible' capital is rarely measured or reported by firms. What are the repercussions?

It is never reported, and ironically, in many cases it's not even known to managers. Repercussions appear on two levels: internally, the company's executives don't have any idea whether

their organizational capital is improving or deteriorating over time or what can be done about it; and externally, the same problem exists for investors. My colleagues and I have found that a deterioration in organizational capital precedes the deterioration of a company as perceived by investors by two or three years. It takes that long before the stock market finally realizes that something is basically wrong, and then the price goes down.

You and your colleagues have developed a firm-specific measure of organizational capital. Can you describe it?

Basically, all companies in a given industry use similar resources. If you look at oil companies, they all have facilities and plants and machinery; they have, of course, employees at all levels; and they spend money on R&D. While all oil companies have access to these three main sets of resources, some of them use the resources much more effectively than others. They may have the same number of employees as their competitor, but their employees might be much better trained, or better motivated. They can spend the same amount on R&D as a competitor, but their systems for incentivizing people and their ability to provide access to the latest academic research may be better than their competitor's. What our measure captures is not just the different sets of resources themselves, but the efficiency of using those resources. Organizational capital is basically an *enabler*: it allows you to use the same resources as your competitors, but to obtain much more productivity from them. Our approach takes the main resources that companies use (as listed in their financial reports) as a given; and then it captures the 'extra efficiencies' that apply to firms that have significant organizational capital.



You have found that by calculating a firm's 'comprehensive value,' you can assess whether it is undervalued or overvalued. Talk a bit about these findings.

That's another methodology that we developed. What we do is, we measure the total intangibles of a company – everything that is missing from the balance sheet – and what we get is a sum value of the firm's intangible assets. Then, from the balance sheet, we take the value of its tangible and financial assets. When we sum up these three components, we get what we call the 'comprehensive value' of the company. Next, we compare this comprehensive value to the market value: if the comprehensive value is larger, the company is under-valued (i.e. it's a good investment); if it's lower, then the company is over-valued. We have extensive tests to show that this works, so that if you use our valuation in a given year, let's say 2005, and you focus on the companies that according to the test are under-valued, in the next two or three years, on average, you will see a significant increase in their stock prices. As I said earlier, it takes time for investors to catch up. Likewise, when you look at companies that are over-valued according to our measure and track them over future years, you will find that their stock price decreases quite substantially.

Generally-Accepted Accounting Principles (GAAP) treat internally-generated intangibles not as investments, but as costs to be expensed. Do you foresee a day when intangibles are accounted for as assets?

It's slightly more complicated than that. We have to make a differentiation between U.S. GAAP and the international accounting rules, because there are important differences. U.S. GAAP treats all internally-generated intangibles (those that the company generates itself, like R&D leading to patents and then to new products and so on) as expenses, as you said, with one exception, and that is 'software development costs' – although most companies in the software industry don't adhere to this. In contrast, intangibles that are acquired through mergers and acquisitions – and there are thousands of them every year – are considered assets, and companies have to value them and put them on their balance sheet. So there is a huge inconsistency.

If firms could relate their IT expenditures or brand enhancement outlays to changes in organizational capital, they could indicate the returns on these investments and guide future resource allocation (i.e., should we invest less or more in IT?) Investors would be eager to incorporate the value of organizational capital into their corporate valuation models. In merger and acquisition cases, the value of this capital should play a prominent role, since it is predominantly tacit and difficult to transfer across firms, and hence of questionable value in acquisitions.

What is the difference between internally-generated intangible assets and acquired ones?

There is no difference, in my view. I once made a presentation to the **Financial Accounting Standards Board** where I argued that there should be no difference, and they said to me, 'But

Professor Lev, in the case of acquisitions you have an arms-length transaction, while internally you don't.' My answer to them was, 'Really? Don't you have arm's-length transactions internally, when more than 80 per cent of your R & D consists of salaries? When you pay your scientists, isn't that a form of arm's-length transaction? Aren't they getting the market rate? What is the difference?' **Coca-Cola** has developed this enormous brand internally, but if you look at its latest balance sheet, you won't see any brand assets listed; you will just see things like cash and securities. Yet if I were to acquire Coca-Cola tomorrow, on my balance sheet, by law I would have to indicate that I had acquired this massive brand. Why should one instance be accounted for, and the other not? The international accounting rules allow for intangibles capitalization, internally-generated, under strict circumstances; they have to be separable, they have to be identifiable, but at least in principle, companies following the international rules can recognize certain internally-generated intangibles as assets.

You admit that capturing intangible assets in an accounting system is a tall order. What initial steps can be taken to end what you call the 'information brownout'?

I would say two things. The first, firms will have to wait for regulators to allow for, and that is to significantly expand the recognition of intangible assets, meaning capitalizing intangibles. For example, some people say that it's very hazardous to capitalize R&D because so many R&D projects fail. That may be true, but most companies don't develop just one thing at a time; they tend to have multiple projects on the go, and these portfolios, in most cases, are very stable. Any asset can fail; you can invest in real estate, and we have seen lately that even these prices can go down. Portfolios of R&D are as stable as any other assets, so the first thing I would suggest for U.S. regulators is to follow the international accounting rules, and maybe even extend them.

The second thing, which is much more important than the first, is to provide more information to investors without affecting the balance sheet. Managers are extremely concerned about putting things on their balance sheet. I say, forget about the balance sheet: just provide good information. Good information is something that in large part, accounting completely misses. Accounting doesn't allow you to make any linkages between inputs and outputs. What you see in the income statement, for example, is revenues; but you have no idea where they are coming from. Are they from new efficiencies? Are they from restructuring? Are they from new market penetration? There is absolutely no indication. It's really a very primitive information system.

I would call on individual managers to provide information about inputs and outputs. In my book [*Intangibles: Management, Measurement and Reporting*] I devote an entire chapter to this template of disclosure. I'll give you an example: think about employee training. Isn't it important for both managers and outsiders to know a) the actual investment in employee training, which no one currently provides, and b) the consequences of this investment? For instance, one consequence might be an effect on the turnover rate.

Presumably, if employees like their company and enjoy what they do, the turnover rate will be lower. As an investor, I want to see some kind of an association between investment in training and lower turnover rates. Then there is the ultimate outcome, which is efficiencies. I would like to see that these trained employees are doing the things that they used to, but better – either with higher quality and/or lower cost and so on. That’s what I mean by linkages. I urge firms to start providing this type of information.

You have noted that your call for enhanced disclosure often triggers certain concerns in the minds of managers. Please address these concerns.

I want to be clear that these are not concerns in my mind, but it’s like an automatic response occurs whenever I speak with managers about greater disclosure. Three things always come up immediately: a) ‘it’s costly’, b) ‘it will benefit our competitors’, and c) ‘it will enhance our litigation exposure’. It’s as if they have been trained by someone to give the same answers.

The cost issue is absurd, because they have the information on R&D costs, on employee training and other things – they just aren’t doing anything with it. Proprietary costs benefiting competitors is somewhat more complicated. Of course in the very initial stages of an R&D project, I wouldn’t recommend giving lots of information about what you are doing; but the things that I’m referring to, your competitors know about. I’ll give you an example. All pharmaceutical and biotech companies provide extremely-detailed information about their product pipeline. If you look at their financial reports, there is page after page of information: “here are the drugs we are working on; here is the stage of each drug’s development, phase one clinical tests, phase two clinical tests; here are the results, here is the prospective market that we are expecting,” etc. This is incredibly-detailed disclosure, and yet no one is harmed, and the simple reason is that when your competitors know what you are doing, in many cases, it can be helpful: if you disclose that you are already quite advanced in developing a certain drug against blood clots, a competitor will think pretty hard before entering this field because they know that you’ve already spent huge amounts of money and you’ll be way ahead of them, so why waste their resources on it?

I dismiss the litigation concern completely, because everything that I’m talking about is factual. Litigation usually comes from prospective statements. Managers may say, “we are developing a product that will revolutionize the field and we’ll get billions of dollars for it,” and then two years later, that’s not the case; or they say “we expect 20 per cent earnings increase” and that doesn’t happen. That’s the sort of thing that creates litigation. But if you give facts, what are people going to sue you for? If you say, “here is what we invested in employee training, here is the change in our turnover rate, here are the efficiencies we have achieved,” and these facts are correct, what kind of exposure will be created? Zero.

On another topic, in a recent paper you posed the question, ‘To Guide or Not to Guide?’, in reference to quarterly earnings

guidance. What is your personal stance on this issue?

In recent years there has been a huge onslaught against quarterly guidance. Influential organizations like the **Business Round Table**, Chambers of Commerce, even highly-respected individuals like **Warren Buffet** have been encouraging companies to stop providing quarterly guidance because it supposedly increases ‘short-termism’. I find this, to say the least, bizarre. Who are these people to tell managers what to do? If managers think that it’s in the interest of their company to provide more information to investors, who is the Chamber of Commerce to tell them not to do it?

I’ve done some research following these calls to end quarterly guidance, and we now have a sample of 222 companies that stopped providing quarterly guidance in recent years. We’ve been tracking two things: who are these companies, and what happens to them after they stop providing quarterly guidance? We have found that those who stop guiding after having done so for at least two years are not role models, to say the least: they are losing companies that have repeatedly disappointed investors by failing to meet analysts forecasts. Then we looked at what happened to these companies afterwards: nothing. We were unable to document a single good thing that came out of it. The things that did happen are what you would expect: some of the analysts that followed these companies stopped doing so, because financial analysts like to give guidance. Most managers like to have lots of financial analysts because it’s a very convenient medium to speak to investors. A lack of guidance can increase the uncertainty about a company. The rule in capital markets that many people don’t recognize is that in contrast with general life, in capital markets, ‘no news is bad news’ and if you stop providing something that investors clearly like to see, it’s not good.

What my colleagues and I are saying is, there are thousands of companies out there that choose not to provide quarterly guidance, and if they believe that this works for them, let them do it; what’s the sense of all the peer pressure? The fact is, financial analysts are going to issue quarterly earnings forecasts either way, so what do they achieve by not guiding? Look at the case of **Google**: on principle, they don’t guide, so from time to time they disappoint stakeholders when their quarterly earnings fall below the consensus. What happens is, the stock is hit extremely hard and when you speak to analysts or investors they say, ‘that’s because we didn’t have any inkling about this disappointment. Had they told us through guidance or other means that this was not going to be a good quarter, then the whole thing would have been moderated.’ As you can see, I’m a big fan of disclosure in most of its forms. **R**



Baruch Lev is the Philip Bardes Professor of Accounting and Finance and director of the Vincent C. Ross Institute of Accounting Research at New York University’s Stern School of Business. The author of *Intangible Assets: Values, Measures and Risks* (Oxford University Press, 2003) and *Intangibles: Management, Measurement and Reporting* (Brookings Institute, 2001), his research is regularly featured in *The Economist*, *Barrons* and other leading publications. For more, visit baruch-lev.com